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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1960

No. 828

JOHN R. UPTON and ANNA L. S. UPTON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MARGARET ST. AUBYN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY TO BRIEF FOR RESPONDENT IN OPPOSITION.

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REPLY TO BRIEF FOR RESPONDENT IN OPPOSITION.

This reply and its length, with one possible exception, is due to statements in Respondent's Brief in Opposition which we respectfully urge are inaccurate and misleading.

I. THE QUESTIONS PRESENTED.

Under 23(m) there are two questions. First, what is the instrument creating the trust?[1] Second, are there pertinent provisions of such instrument apportioning the allowable deduction for depletion between the income beneficiaries and the trustees?

Sec. 23(m) refers to pertinent provisions of the instrument creating the trust. There is no provision of the Sloan will requiring "the trustees to retain sufficient royalty income to preserve the trust corpus." (Brief in Opposition p. 2.) There are provisions in the Sloan will directing that "said Trustees shall receive the rents, issues, profits and income of said property, and after paying all necessary and proper expenses incurred by them in the administration of their trust shall dispose of the net rents, issues, profits and income of said property" (R. 114) to his wife for her life and then to his two daughters in equal shares.

II. THE STATUTE AND REGULATIONS INVOLVED.

The Brief in Opposition (p. 3) omits the first sentence of Section 39.23(m)-1(c) of Reg. 118 which reads: "The adjusted basis of depreciable property is returnable through annual depreciation deductions." The materiality of this omission is hereinafter set forth, infra pp. 6-7.

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[1]The Brief in Opposition (p. 2) starts its statement of question presented with the words "whether the provisions of a will creating a trust . . . ." This should be taken as a concession that the will is the instrument creating a trust.

III. INACCURATE AND MISLEADING STATEMENTS.

(a) The Brief in Opposition (p. 9) asserts that "The very amount of the royalties ordered retained, 27½%, indicates that it was intended to be a reserve for depletion, and was ordered to be retained on the theory that, in conformity with the testator's intention, that portion represented a return of capital and not 'income' available to the income beneficiaries. No other basis for the court's order is apparent, and the taxpayers have suggested none." We suggest that this statement is both inaccurate and misleading.

Another basis for the California court's order is apparent. The taxpayers have suggested and do now suggest another basis.[2] It is apparent and suggested that there was no authority in the will to execute the Richfield agreement for a term which might extend beyond the duration of the trust; the agreement was necessary to prevent drainage; the court had equitable powers to authorize said agreement and in exercise of those powers it could and did require an allocation of the royalty income.

If before January 11, 1961 there was a question whether there was any other basis it was laid to rest by the California court's decree of January 11, 1961. That decree both found and determined "That the authority to execute the Richfield agreement and other agreements for a period beyond the termination of the trust was conditioned by said decree upon the retention of some income because, and only because, such agreements were not authorized by

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[2]It was suggested as early as oral argument. Also see subdivision Sixth of the first petition for rehearing in the Court of Appeals (pp. 34-40).

the will, and this Court did so in the exercise of its equitable powers;" (Appendix to Petition for Writ of Certiorari, p. 37)

27½% as "The very amount of the royalties ordered retained" does not indicate any intention of the testator to create a depletion reserve. Percentage depletion was never heard of until years after Mr. Sloan's death. Moreover, the 1953 decree allocates income from "other minerals" on the same basis. Percentage depletion goes from a low of 5% on brick and tile clay, and on granite, sand and shale, to a high of 23% on sulphur, with many others at 10% and 15% under Section 114(b)(4).

The statement that the retained royalties were "ordered to be retained on the theory that, in conformity with the testator's intention, that portion represented a return of capital and not 'income' available to the income beneficiaries" (Brief in Opposition p. 9) is directly repudiated by the California court's decree of January 11, 1961. That decree both found and determined that the trustees were not ordered by said decree to retain 27½% of royalty income on the theory that the testator intended 27½% of the royalties to represent return of capital; 27½% as percentage depletion had not been heard of at the time of the testator's death. (Finding 16, Appendix p. 29; Decree parag. I(iii) Appendix p. 36)

The state court's order directing the retention of income is a question of California, not federal, law and is binding on the court below.

(b) The Brief in Opposition (p. 10) asserts "A portion of the royalties could be, and was, withheld from the in-

come beneficiaries only because the trust instrument, as interpreted by the California court, required such retention in order to preserve the *corpus* of the trust." This assertion is both inaccurate and misleading. The California court did not order the retention of royalty income to preserve corpus. If before January 11, 1961 there was a question, it was laid to rest by the California court's decree of that date (Finding 26, Appendix p. 32; Decree parag. I(xiii) Appendix p. 39). The California court is deciding state, not federal, law.

(c) The Brief in Opposition (pp. 2, 7 and 10-11) repeatedly refers to Sec. 39.23(l)-1 of Regulations 118. This regulation does not deal with depletion. It deals with depreciation. Let us assume that the Sloan will specifically required that the trustees shall receive the rents, issues, profits and income of said property, and after paying all necessary and proper expenses incurred by them in the administration of their trust and after making due allowance for keeping intact an amount equal to the fair market value at the time of his death of trust property producing the royalty income by retaining a reasonable amount of the royalties for that purpose, shall dispose of the net rents, issues, profits and income to his wife for life and then to his two daughters in equal shares. Let us assume that the fair market value at the time of death of the mineral interests producing the Richfield royalties was $5,445.25 as found by the Tax Court. We submit such directions are not pertinent provisions within the meaning of Sec. 23(m) apportioning the allowable deduction for depletion entirely to the trustees to the exclusion of the beneficiaries. Otherwise hundreds of thousands of dollars

of percentage depletion have been thrown away to preserve a corpus with a value of $5,445.25.

To get to the depreciation section of Regulations 118 (39.23(l)-1) the respondent relies on Section 39.23(m)-1-(c). That section reads as follows:

> "(c) The adjusted basis of depreciable property is returnable through annual depreciation deductions. Depreciation and depletion deductions on the property of a corporation are allowed to the corporation and not to its shareholders. The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion."

Respondent in quoting that section omits therefrom, as we have before pointed out, the very portion which defeats his entire argument, namely the following language:

> "The adjusted basis of depreciable property is returnable through annual depreciation deductions."

That is the basis which is returnable through cost depletion (Sec. 114(b)(1) of the Internal Revenue Code of 1939) but it is not the basis for percentage depletion (Sec. 114(b)(3) of the Internal Revenue Code of 1939).

On November 1, 1951 (the effective date for allocation of income under the 1953 decree) the adjusted basis for the interests producing the Richfield royalties and the Pleasant Valley Royalties was nil.[3] This is so because the

[3]This is the arithmetic showing that the adjusted basis for each interest was nil at the beginning of the tax years in question. All

statute required reduction of acquisition value by the amount of depletion allowed as deductions in computing net income under federal income tax law, but not less than the amount allowable thereunder. (Sec. 113(b)(1)(B) of the Internal Revenue Code of 1939)

We submit that an example in a regulation concerning apportionment of depreciation in respect to adjusted basis is not one of "the principles governing the apportionment of depreciation" in respect to percentage depletion far in excess of adjusted basis. An example is never a principle. The regulations, concerning the principles governing the apportionment of depreciation are as follows:

> "In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively." (Brief in Opposition p. 2)

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figures except as otherwise noted and except for percentage depletion are taken from p. 4 of the Brief in Opposition.

(a)	Pleasant Valley value at acquisition		$19,289.90
	Royalties received prior to 10/31/51	$121,000.00	
	Percentage depletion thereon		35,750.00
	Adjusted basis 10/31/51		$ Nil
(b)	Cuyama mineral interest value at date of death		$ 5,445.25
	Royalties received in 1951 prior to 10/31/51 (R. 119)	$479,656.67	
	Percentage depletion thereon		131,905.58
			$ Nil

(There is no adjustment of basis below nothing.)

This language basically follows the language of 23(m) and directs that the allowable deduction for depletion be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each unless there are pertinent provisions of the instrument creating the trust apportioning such deduction.

To the extent that the example concerning depreciation conflicts with Sec. 23(m) or with Sec. 114(b)3 it is void.

(d) The Brief in Opposition (pp. 8-9) states that the 1953 decree required "the trustees to set up a reserve to preserve the corpus of the trust for the benefit of the remaindermen." We suggest that this statement is both inaccurate and misleading.

The California court itself has said that the retained royalties were not "required to be set aside as a reserve for depletion," (Decree of January 11, 1961—Finding 14, Appendix p. 28; Decree parag. I(i) Appendix pp. 34-35) nor "to preserve corpus." (Decree of January 11, 1961, Finding 26, Appendix p. 32; Decree parag. I(xiii) Appendix p. 39).

Even if we look at the 1953 decree it never uses the word "reserve," never uses the word "preserve," and never uses the word "corpus"[4] in reference to oil royalties.

(e) The Brief in Opposition (p. 9) cites Section 239 of the Restatement of Trusts. It does not tell this Court that comment (g) to that section of the Restatement provides that whether oil lands are productive or unproductive at

[4]The 1953 decree uses the word "corpus" three times. See Petition p. 7 and Footnote 4.

the time of the creation of the trust, receipts are to be apportioned so as to "preserve the value of the principal at the time of the creation of the trust."

(f) The Brief in Opposition (p. 6) inserts into the decree the words "For purposes of distribution of the corpus. . . ." Those words are not in the 1953 decree. (Findings 36, 39 and 59, Br. Appendix[5] pp. 44-7 and 54-5; Decree parags. 13, 14 and 15, Br. Appendix[5] pp. 65-68) There is no doubt but that the state court ordered that upon termination of the trust the retained royalties "be treated in all respects as if it were part of the property distributed to the trustees by said decree of final distribution * * *." (Brief in Opposition p. 6) However, "as if it were" connotes a condition contrary to the fact. In other words, the retained royalties were not corpus but were to be treated as if they were.

(g) The Brief in Opposition (p. 10) asserts that "In this case, unlike *Little*, the will gave the trustees no discretion to retain income . . .; the will was mandatory in directing that all *income* be distributed to the income beneficiaries." This assertion is inaccurate and misleading. The will in the *Little* case after directing total monthly payments of $300 to two others directed that "All other net income from my estate shall be paid to my mother, Mary Jane Little, during her lifetime." (*Little's Estate v. Commissioner*, 274 F. 2d 718 at 721)

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[5]Br. Appendix refers to the appendix to petitioners' opening brief in the court below.

IV. THE CALIFORNIA COURT'S DECREE.

Whether the Sloan will contained a pertinent provision apportioning the allowable deduction for depletion entirely to the trustees to the exclusion of the income beneficiaries is admittedly a federal question. The state court never has attempted to determine the answer to that question. That question can be answered without consideration of the state court's decree, if the will is the instrument creating the trust. We cannot conceive that a decree entered 30 years after the distribution of decedent's estate can be the instrument creating the trust.

However, to the extent that "The 1953 decree of the California court, entered in an adversary proceeding, was fully binding as an adjudication of property rights under the trust instrument," as the Brief in Opposition asserts (p. 8),[6] such decree is a determination of California law in direct relation to the Sloan trust and is binding on the court below. *Freuler v. Helvering* (1934) 291 U.S. 35, reversing CA 9th, 62 F. 2d 733 and *Blair v. Commissioner* (1937) 300 U.S. 5, reversing CA 7th, 83 F. 2d 655. If the decree of 1953 is an adjudication of property rights, then the decree of January 11, 1961 is likewise an adjudication of property rights. The recent decree, still not final, is an adjudication of California law. It did not attempt to determine whether the Sloan will was the instrument creating the trust under Sec. 23(m) nor whether the will had pertinent provisions under Sec. 23(m) apportioning the allowable depletion deduction.

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[6]The opposition later says "The 1953 decree, on the other hand, did adjudicate substantive property rights . . ." (Brief in Opposition p. 10)

Granted this decree is not yet final. That, in our opinion, does not justify the following statement of the Brief in Opposition (pp. 9-10), namely: "That decree, approving the trustees' 28th account, was likewise entered in non-adversary proceedings and was an attempt simply to change the characterization of the 1953 decree, for tax purposes, without otherwise affecting any substantive rights." There is nothing in the record before this Court or the court below concerning this decree unless it be the decree itself. The decree shows that the state court "being fully advised and having considered the evidence, including the opinion of the federal court hereinafter referred to, as well as the briefs before that court, and the memorandum of questions" made certain findings (Appendix p. 25) and "now being FULLY AND FAIRLY ADVISED in the premises as to the questions at issue, and that a federal court has otherwise interpreted said decree, does hereby ORDER, ADJUDGE, DECREE AND ADVISE as follows," (Appendix p. 34): The trustees were entitled to seek the instructions of the court having supervision of the trust. To derogate from the authority of that conclusion and of the decree it commanded, so far as the question is one of state law, would be wholly unwarranted in the exercise of federal jurisdiction. *Blair v. Commissioner* (1936) 300 U. S. 5, 57 S. Ct. 330.

The decree purports to decide issues regularly submitted and not to be in any sense a consent decree. The decision of the court having jurisdiction of the trust until reversed or overruled, establishes the law of California respecting distribution of the trust estate. The rights of the beneficiaries are property rights and the court has

adjudicated them. *Freuler v. Helvering* (1934) 291 U.S. 35, 54 S. Ct. 308.

The California court is deciding questions of California law. We take but one illustration from the opinion in the court below, but it is one that goes to the heart of the problem, namely whether hundreds of thousands of dollars are needed to preserve a corpus of nominal value[7] and whether that is a question of California law to be decided by a California court.

The opinion below in part said: "The Alameda County court apparently proceeded on the theory that the present value of the corpus is to be preserved. We will not go behind that determination." (Appendix p. 13)

The California court never made any such determination or finding of such value. Assuming, without conceding, that the California court determined that the value of the corpus was to be preserved, that determination would be one of California law. Likewise, whether such value is to be determined at the time of the creation of the trust or some thirty years later is a determination of California law.

If whether the California court was preserving present value was unclear before, it is made abundantly definite by the California court in its decree of January 11, 1961. There, the California court on the subject of the last quoted statement from the opinion below found, decreed and advised as follows:

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[7]It would make no substantial difference if we used $5,445.25 as found by the Tax Court (R. 116).

"That said opinion of the United States Circuit Court of Appeals for the Ninth Circuit, filed September 27, 1960, in speaking of said decree, in part states that this Court 'apparently proceeded on the theory that the present value of the corpus is to be preserved'; the reference to 'present value' presumably means value at or about the time of the hearing or of the entry of said decree; there was no evidence whatever before this Court as to the value of either the Cuyama mineral interests or the Pleasant Valley interest at the time of hearing before this Court, or at the time of said decree; there was evidence before this Court only that the value of all of the mineral rights in the Cuyama Area owned by testator 'was $1,000 and no more at the time of his death and at all times thereafter prior to January 1, 1945'; this Court made no findings whatever as to the value of either the Cuyama interests or the Pleasant Valley interests at the time of the hearing, or at the time of said decree; this Court did not proceed on the theory that the present value of the corpus was to be preserved; there was no evidence of such value; there was no finding of such value; written findings on a material issue are mandatory; a judgment or order not supported by findings of fact, when such findings have not been waived, is void; substantial evidence is required to support the findings and judgment;" (Finding 25, Appendix pp. 31-2; Decree I-xii Appendix pp. 38-9)

The question whether the value of testamentary trust property to be preserved under California law is the value at the time of the creation of the trust (the date of testator's death) or at the time of the hearing of the Nineteenth account and report is a question of California

property law, not a question of federal income tax law. It follows that if the 1953 decree determined property rights the 1961 decree did also.

CONCLUSION.

There is a great divergence between the court below and the California court in respect to the latter's 1953 decree as to California law. That divergence is unseemly and should be settled by this Court determining once again, as it has in the past, that to the extent state law is determinative of any material point in the controversy, the state court's decrees are binding on the court below. Certiorari should be granted to correct that unseemly divergence.

Dated, San Francisco, California,
April 24, 1961.

Respectfully submitted,
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